No. 85-879

Supreme Court, U.S.
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In the Supreme Court of the United States

OCTOBER TERM, 1985

THOMAS INTERNATIONAL LIMITED, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

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Solicitor General
Department of Justice
Washington, D.C. 20530
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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

Petitioner challenges the court of appeals' holding that it failed to qualify as a domestic international sales corporation (DISC) for the tax years at issue because of noncompliance with applicable Treasury Regulations. The decision below is correct. Petitioner does not allege, nor is there, a conflict among the circuits on the question presented. The question has little prospective importance, since the DISC provisions have been superseded for tax years after 1984. The case warrants no further review.

1. Thomas Built Buses, Inc. (TBB) manufactures buses for sale in domestic and export markets. Petitioner was organized in 1973 as a wholly-owned subsidiary of TBB to serve as a commission agent for TBB's export sales (Pet. App. SA2). Petitioner was created in order to take

advantage of the tax benefits provided for DISCs by Sections 991 through 997 of the Internal Revenue Code.[1]

Congress enacted the DISC provisions to encourage exports of domestic products. S. Rep. 92-437, 92d Cong., 1st Sess. 6-7, 90 (1971). Although Congress conferred substantial tax benefits on DISCs, it established numerous and stringent requirements that a corporation must meet to qualify. The statutory requirement relevant here is set forth in Section 992(a)(1)(B). That Section provides that a corporation can qualify as a DISC only if "the adjusted basis of [its] qualified export assets * * * at the close of the taxable year equals or exceeds 95 percent of the sum of the adjusted basis of all [its] assets * * * at the close of the taxable year." This requirement is designed to ensure that the tax-deferral benefit of the DISC provisions is available only with respect to earnings that are reinvested in the export business.

"Qualified export assets" are defined to include "producer's loans" and certain "accounts receivable" held by a DISC (I.R.C. § 993(b)(3) and (5)). Generally speaking, a "producer's loan" is a species of loan made by a DISC to its parent or to another related party; a debt obligation must satisfy exhaustive statutory criteria to qualify as a "producer's loan." See I.R.C. § 993(d). The Treasury Regulations provide that "accounts receivable" generally include "trade receivables." Treas. Reg. § 1.993-2(d)(1). The Regulations further provide, however, that trade receivables representing unpaid export commissions owed to a DISC by its parent, or by another related party, constitute "qualified export assets" only if they are "paid no later than 60 days following the close of the taxable year of the DISC

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[1]Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as amended, as in effect for the tax years in issue (the Code or I.R.C.).

during which the transaction occurred." Treas. Reg. § 1.994-1(e)(3); see Treas. Reg. § 1.993-2(d)(2). By requiring prompt payment of export commissions, the Regulations are designed to prevent a DISC from lending money to related parties for indefinite periods of time by deferring collection of such amounts, and thus circumventing the rigorous limitations that Congress placed on "producer's loans."

For its fiscal tax years ending March 31, 1977, and March 31, 1978, petitioner earned commissions from TBB in the respective amounts of $708,231 and $329,057 on export sales of TBB's buses. Petitioner did not receive payment from TBB for these commissions, however, until December 15, 1977 (in the case of the fiscal 1977 commissions) and June 1, 1978 (in the case of the fiscal 1978 commissions). The accrued commissions were thus paid 8½ months after the close of petitioner's 1977 tax year, and 62 days after the close of its 1978 tax year, respectively. See Pet. App. 4a, SA2-SA3.

On audit, the IRS determined that petitioner's accrued export commissions were not "qualified export assets" because TBB did not pay them off within 60 days after the close of petitioner's tax years, as the Regulations require. That determination caused petitioner to fail the "95% qualified export assets test" for each year, with the result that petitioner did not fulfill the statutory criteria for DISC status. See Pet. App. 4a-5a, SA3. The Commissioner asserted deficiencies in tax flowing from petitioner's failure to qualify as a DISC for 1977-1978.

Petitioner paid the deficiencies and, following the denial of its administrative claim for refund, filed this refund suit in the Claims Court. That court granted summary judgment for petitioner (Pet. App. SA1-SA15). It held that the Regulations' 60-day payment rule for accrued export commissions was invalid, stating that the rule "impose[d] an

additional arbitrary requirement not found in or authorized by any statutory provision" (*id.* at SA13 (footnote omitted)).

The court of appeals unanimously reversed (Pet. App. 1a-11a). It rejected petitioner's argument that the 60-day payment rule was inconsistent with the statute, an argument based on the theory that the statutory term "accounts receivable" (I.R.C. 993(b)(3)) necessarily included *all* export commissions receivable, regardless of when paid. "The term 'accounts receivable,' " the court of appeals said, "ordinarily connotes amounts due in return for goods or services supplied. A commission paid in return for selling activities, either a fixed amount or a percentage of the sales price, normally would not be described as an account receivable" (Pet. App. 7a). Since the term "accounts receivable" thus did not "unambiguously include" all species of unpaid export commissions, the court held that the Commissioner "had leeway to define and apply the statutory term so as properly and effectively to implement the congressional plan and purpose" (*id.* at 8a).

The court further concluded that the 60-day payment rule was "harmonious with the origin and purpose of the DISC legislation," since it ensured that taxpayers could not use export commissions as "a means of evading the strict requirements and limitations Congress placed upon producer loans" (Pet. App. 8a-9a (quotation marks omitted)). The producer-loan restrictions, the court noted, "were designed to insure that a producer would not divert the tax-immunized DISC funds into non-export activities" (*id.* at 9a). The 60-day payment rule for export commissions furthered this legislative objective since, "[u]nless promptly paid, commissions due a DISC from its parent [would] in effect create an open line of credit, upon which the parent [could] draw at will for whatever purposes it wishe[d]"

(*ibid.*). The court also rejected petitioner's alternative contention that TBB's belated payment of the export commissions achieved "substantial compliance" with the 60-day payment rule, holding that literal compliance with the Regulations was required and that petitioner in any event "d[id] not establish substantial compliance" (*id.* at 11a).

2. The decision below is correct. This Court has repeatedly held that courts "must defer to Treasury Regulations that 'implement the congressional mandate in some reasonable manner' " and that such Regulations " 'must be sustained unless * * * plainly inconsistent with the revenue statutes.' " *Commissioner* v. *Portland Cement Co.*, 450 U.S. 156, 169 (1981) (quoting *United States* v. *Correll*, 389 U.S. 299, 307 (1967), and *Commissioner* v. *South Texas Lumber Co.*, 333 U.S. 496, 501 (1948)). Accord, *e.g.*, *National Muffler Dealers Ass'n* v. *United States*, 440 U.S. 472, 476-477 (1979). The court of appeals correctly held that the challenged Regulations offer a reasonable interpretation of the statutory phrase "accounts receivable," particularly when that term is considered in light of the overall statutory scheme and Congress's purpose in enacting the DISC provisions. As petitioner concedes (Pet. 6-9), the decision below accords with the decisions of every other court of appeals that has considered the validity of the Regulations' 60-day payment rule. Those courts have held, consistently with the decision below, both that the 60-day payment rule is valid and that taxpayers must achieve literal (and not merely "substantial") compliance with the DISC regulatory framework. See *LeCroy Research Systems Corp.* v. *Commissioner*, 751 F.2d 123, 125-126 (2d Cir. 1984); *CWT Farms, Inc.* v. *Commissioner*, 755 F.2d 790, 796-797, 799-802 (11th Cir. 1985), aff'g 79 T.C. 1054 (1982), petition for cert. pending, No. 84-1966.[2]

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[2]The pending petition in *CWT Farms* presents an additional question not presented by the instant case, viz., whether the Commissioner

Petitioner's contention that the decision below "conflicts with certain decisions of this Court concerning the scope of the Treasury's authority in promulgating interpretative regulations" (Pet. 6) is wholly insubstantial. The standard of review employed by the court of appeals in assessing the Regulations' validity is precisely the standard that petitioner states to be correct under this Court's decisions. Compare Pet. App. 6a-7a with Pet. 6. What petitioner disagrees with is not the Federal Circuit's view of the scope of the Treasury's rulemaking authority, but the Federal Circuit's conclusion that the challenged Regulations are not "plainly inconsistent" with the statute under which they were promulgated (*Commissioner* v. *South Texas Lumber Co.*, 333 U.S. at 501). See Pet. 8-9. Petitioner's disagreement, in other words, is with the court of appeals' conclusion that these particular Regulations are valid, a conclusion as to which there is no conflict whatsoever, either among the circuits or with any decision of this Court.

Finally, there is no merit to petitioner's assertion (Pet. 9-14) that the question presented has sufficient importance to warrant certiorari in the absence of a conflict. As we noted in our brief opposing certiorari in *CWT Farms* (84-1966 Br. in Opp. at 10), the question of the validity of the 60-day payment rule has little prospective importance. The

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abused his discretion (see I.R.C. § 7805(b)) in giving retroactive effect to the challenged Regulations. See 84-1966 Pet. at 9-11. While the courts of appeals have unanimously upheld the validity of these Regulations, the Second and Eleventh Circuits, as we noted in our brief opposing certiorari in *CWT Farms* (84-1966 Br. in Opp. at 10-11), have disagreed as to the propriety of applying them retroactively. Since Treas. Reg. § 1.994-1(e)(3), setting forth the 60-day payment rule, was adopted in final form on September 29, 1976 (41 Fed. Reg. 43141), the question of retroactive application is not presented in this case, which involves petitioner's DISC status for its fiscal years ending March 31, 1977, and March 31, 1978. (We are sending a copy of our brief in *CWT Farms* to petitioner's counsel.)

DISC provisions as a whole have been superseded for tax years after 1984. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 801, 98 Stat. 985 (enacting I.R.C. §§ 921-927) (replacing DISC system with system of foreign sales corporations (FSCs)).

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

CHARLES FRIED
Solicitor General

JANUARY 1986

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"gross receipts" to include the gross receipts on the sale or rent of property even where the DISC receives only commissions on the sale by the supplier, and in § 994(b), which authorizes the Secretary to prescribe rules for the allocation of income between DISC and supplier "in the case of commissions." If a commission DISC, which ordinarily could not be expected to have substantial tangible assets, were required to exclude its commissions receivable from qualified export assets while including them in total accrued assets, it is problematical how many, if any, of such agents could qualify as DISCs under the 95 percent qualified export assets test. To avoid disqualification of commission DISCs "accounts receivable * * * which arise by reason of transaction of such corporation [the DISC]" must necessarily be understood to include sales in which the DISC is assigned by the producer the role of commission agent rather than reseller.

Finally, even if there were an ambiguity with respect to whether or not the accounts receivable which arise by reason of sales transactions of the DISC include those sales in which the DISC is merely the agent, it has been resolved by provisions of Treas. Reg. § 1.993-2(d)(2) other than the 60-day payment requirement. The regulation unconditionally includes in accounts receivable which arise by reason of transactions of the DISC commissions receivable from any producer other than a related one no matter when paid. It also includes commissions receivable from a related supplier if paid within 60 days after the close of the year. The requirement that the commissions receivable from the latter be collected within the 60 days may not reasonably be deemed to be merely an interpretation of any statutory phrase but is an additional requirement superimposed thereon for another purpose.

In a second prong of its reasoning the Tax Court came to grips with such other purpose. It held that the valid-

ity of the 60-day payment provision of § 1.992-2(d)(2) may be sustained as a reasonable means of preventing the use of uncollected commissions receivable as a device to frustrate the "producer's loan" provisions of the legislation, which restrict the uses for which a DISC may lend its tax-free funds to an export producer while continuing to treat the obligation as a qualified export asset of the DISC. *CWT Farms*, 79 T.C. at 1066-67. Section 993(d) provides that such a loan must be evidenced by an instrument with a stated maturity of not more than 5 years; it may only be made to a person engaged in the United States in the manufacturing, production, growing or extraction of export property; it must be designated as a producer's loan when made; it is limited by a formula to the amount of the borrower's export related assets; and it is further limited to the extent that the borrower increases its investment in export related inventory and plant plus research and experimental expenditures during the year. The court stated that if the regulation cannot be justified under the grant of regulatory authority in § 994(b) it can again be justified under the general authority of § 7805 as a reasonable interpretation of § 993 dealing with what constitute qualified export assets.

It must be concluded that this justification for the regulation at issue is likewise not sustainable as an interpretation of any statutory language. It is an effort to close a loophole by adding a requirement to the statute which Congress failed to adopt.

As a general matter the regulations of an administrative agency charged with the duty to carry out a congressional mandate are entitled to great weight; but this general principle of deference only sets the framework for judicial analysis and does not displace it. *United States v. Vogel Fertilizer Co.*, 455 U.S. 16, 24 (1982). It is hornbook law that the Treasury has no power to promulgate a regulation which either adds an exception

to or supplies an omission in a statute which it believes Congress should have included but did not. *Commissioner v. Acker*, 361 U.S. 87 (1959); *Helvering v. Credit Alliance Corp.*, 316 U.S. 107, 113 (1942); *Caterpillar Tractor Co.*, 218 Ct. Cl. at 526, 589 F.2d at 1045; *Durbin Paper Stock Co. v. Commissioner*, 80 T.C. 252, 261 (1983).

In some instances Congress has delegated to the Treasury authority to adopt legislative or rule-making regulations with appropriate standards necessary to the administration and enforcement of broad statutes with varieties of applications and opportunities for tax avoidance which Congress could not reasonably anticipate upon enactment. *See e.g.*, I.R.C. §§ 453 (relating to accounting for income on installment sales), 611(a) (allowing a reasonable allowance for depletion), and 1502 (relating to consolidated returns). And such regulations have been upheld as having the force of law. *Commissioner v. South Texas Lumber*, 333 U.S. 496, 503 (1948); *Commissioner v. Portland Cement Co. of Utah*, 450 U.S. 156, 169 (1981); *American Standard, Inc. v. United States*, 220 Ct. Cl. 411, 416-17, 602 F.2d 256, 260 (1979); *Garvey v. United States*, 1 Cl. Ct. 108, 113 (1983). *aff'd*, 726 F.2d 1569 (Fed. Cir. 1984), *cert. denied*, 53 U.S.L.W. 3232 (U.S. Oct. 2, 1984) (No. 83-1855). But § 7805 has been held not to be a source of delegation of such legislative authority. *Vogel Fertilizer Co.*, 455 U.S. at 24; *Rowan Cos. v. United States*, 452 U.S. 247, 253 (1981).

The vice in defendant's adoption of the regulatory requirement that payment of commissions receivable is to be made within 60 days of the close of the year on pain of rejection of the account as a qualified export asset is that it attempts to resolve a question of substance versus form by making conclusive against the taxpayer what would otherwise be only a single factor in that factual inquiry. It denies the taxpayer the opportunity to prove that the funds which could have been used to pay the

commissions were in fact used by the related supplier as export assets for purposes consistent with those permissible for producer's loans. And it also makes irrelevant any proof that the failure of the agent to receive payment of the commissions within the 60 days may have been for bona fide reasons, such as hardship, inadvertence, failure of the customer to make prompt payment, uncertainty as to account or difficulty in computation, rather than as a device to circumvent the producer's loan restrictions. In so doing it imposes an additional arbitrary requirement not found in or authorized by any statutory provision.[3]

In other instances where Congress has concluded that actual payment within a limited period after the close of the taxable year should be a proper test of the bona fides of accruals of claimed obligations for expenses owed to related taxpayers, it has not deemed the general authorization to the Secretary of the Treasury to adopt needful regulations sufficient to allow him to disallow such obligations. It has reserved for itself the express delineation of the kinds of expenses which may be disallowed, the number of days in which payment must be made, and the nature of the pertinent relationship between the taxpayers. I.R.C. § 267 disallows deductions, which would otherwise be allowable, for the amounts of accrued trade or business expenses (under § 162), for interest (under § 163), and for expenses for the production of income or conservation of property held for the production of income (under § 212), which are not includible in the income of the related taxpayer unless received, if they are not paid within 2½ months of the close of the taxpayer's taxable year. At the least, it would be anomalous

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[3] The fact that defendant concedes that, if the challenged regulation is invalid, it has no other defense on the merits also tends to support the inference that the regulation is arbitrary as applied to the plaintiff's circumstances in this case.

to conclude that Congress authorized the Treasury in its discretion to disallow an obligation as lacking in bona fides if the taxpayer did not pay it within 60 days after the close of the taxable year, while Congress itself thought a taxpayer should have 2½ months to make payment of an accrued obligation to a related taxpayer before it is deemed not bona fide.

Defendant seeks to draw some inference favorable to the validity of the challenged regulation from the fact that plaintiff does not contest the validity of Treas. Reg. § 1.994-1(e)(3)(i), which, *for purposes of the intercompany pricing rules*, provides that "[t]he amount of a transfer price (or reasonable estimate thereof) actually charged by a related supplier to a DISC, or a sales commission (or reasonable estimate thereof) actually charged by a DISC to a related supplier, in a transaction to which section 994 applies must be paid no later than 60 days following the close of the taxable year of the DISC during which the transactions occurred". But there are significant differences between § 1.994-1(e)(3)(i) and § 1.993-2(d)(2). I.R.C. § 994(b) directs the Secretary to prescribe rules for the application of that section in the case of commissions, rentals and other income, whereas neither I.R.C. §§ 992 nor 993, which set forth the prerequisites for qualification as a DISC has any comparable direction or authorization. Moreover, the consequence of a violation of § 1.994-1(e)(3)(i), which deals with failure to pay the purchase price, as well as commissions, within 60 days, may be far less severe. It results only in a change in the allocation of the income; whereas violation of § 1.993-2(d)(2), by failure to pay commissions within the 60 days, causes disallowance of the account payable as a qualified export asset and may result in the complete termination of DISC qualification and taxation of its entire accumulated income to its shareholder in a single year. *See* I.R.C. § 995(b)(2).

In any event, it is unnecessary to decide at this time whether or not § 1.994.1(e)(3) is valid, since it is sufficient for purposes of the instant case that adoption of the portion of that regulation dealing with commissions, to disqualify a corporation as a DISC under the § 992 test, is in itself unauthorized.

CONCLUSION

Defendant conceded in its brief and on oral argument that if Treas. Reg. § 1.993-2(d)(2) is not dispositive of plaintiff's complaint it has no other defense on the merits. Since it is determined herein that the regulation is invalid, the pleadings and admissions on file indicate that there is no genuine issue of material fact and that plaintiff is entitled to judgment as a matter of law.

The pleadings indicate that, as a result of the Commissioner's deficiency assessment attributable to the issue decided herein, for the year 1977 plaintiff overpaid $312,803 and for 1978 $140,917 in taxes, together with assessed interest of $123,053.16, and that payment of the $576,773.16 total was made on March 8, 1981. Plaintiff is entitled to refund of this sum with interest from March 9, 1981, as provided by law, and the clerk is directed to enter judgment accordingly.

/s/ Philip R. Miller
PHILIP R. MILLER
Judge

IN THE UNITED STATES CLAIMS COURT

No. 449-81 T

THOMAS INTERNATIONAL LIMITED

v.

THE UNITED STATES

[Filed Oct. 12, 1984]

JUDGMENT

Pursuant to the opinion of October 12, 1984, it was held that plaintiff is entitled to recover.

IT IS ORDERED AND ADJUDGED this date, pursuant to Rule 58, that plaintiff recover of and from the United States the sum of $576,773.16, plus interest from March 8, 1981, as provided by law.

FRANK T. PEARTREE
Clerk of Court

By: /s/ Debra L. Samlet
Deputy Clerk

NOTE: As to appeal, 60 days from this date, see FRAP 4(a)

SA-17

IN THE UNITED STATES CLAIMS COURT

No. 449-81T

THOMAS INTERNATIONAL LIMITED

v.

THE UNITED STATES

(Filed October 15, 1984)

ERRATA

Please make the following correction in the Opinion on Cross-motions for Summary Judgment filed October 12, 1984, in the above case:

Page 10, second complete paragraph, line 3 from the bottom of the page, the word "account" should be "amount".

/s/ Philip R. Miller
PHILIP R. MILLER
Judge